

In the Supreme Court of the United States

OCTOBER TERM, 1982

DAILY INCOME FUND, INC. AND
REICH & TANG, INC., PETITIONERS

v.

MARTIN FOX

ON WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE SECURITIES AND
EXCHANGE COMMISSION AS AMICUS CURIAE
IN SUPPORT OF AFFIRMANCE

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QUESTION PRESENTED

Whether an investment company security holder must make a demand upon that company's board of directors prior to initiating an action under Section 36(b) of the Investment Company Act of 1940, 15 U.S.C. 80a-35(b), challenging the compensation paid to the company's investment adviser.

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INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION

Congress has given the Securities and Exchange Commission responsibility for enforcing the federal securities laws, including the Investment Company Act of 1940 ("the Act"), 15 U.S.C. (& Supp. V) 80a-1 *et seq.* A major purpose of the Act is to protect investment company security holders against harm resulting from the conflicting interests of the company's directors and investment adviser, on the one hand, and its security holders, on the other. One common abuse resulting from such conflicts concerns the compensation paid to the company's investment adviser.

Section 36(b) of the Act, 15 U.S.C. 80a-35(b), the statutory provision at issue in this case, grants security holders and the Commission the right to sue investment advisers in order to recover excessive fees. Security holder suits under Section 36(b) provide a necessary supplement to the Commission's own enforcement authority under this Section. Cf. *Mills v. Electric Auto-lite Co.*, 396 U.S. 375, 382 (1970); *J. I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964).

The Commission believes that a requirement of prelitigation demand on directors in security holder actions under Section 36(b) would serve no meaningful purpose and could frustrate full recovery of excessive fees because of delays necessarily associated with demand. Furthermore, if this Court should hold that a director demand requirement applies in such actions, it is important, in the Commission's view, that the directors' refusal to pursue a claim not restrict a security holder's right to institute and maintain suit. Any such restriction would undermine the effectiveness of security holder actions and would place an undue burden on the Commission's limited enforcement resources.

STATEMENT

Respondent Martin Fox, a security holder of petitioner Daily Income Fund, Inc., a registered investment company, brought suit pursuant to Section 36(b) of the Investment Company Act of 1940 in the United States District Court for the Southern District of New York, seeking recovery on the Fund's behalf of allegedly excessive advisory fees paid by the Fund to its investment adviser, petitioner Reich & Tang, Inc. ("R&T"). The complaint alleged that R&T had breached its fiduciary duty to the Fund with respect to receipt of compensation because its fee was based upon a fixed percentage of the assets under management and did not take into account economies of scale realized when the size of the Fund substantially increased. The complaint stated that R&T's annual man-

agement fee amounted to one-half of one per cent of the Fund's net assets, which rose from approximately \$75 million in 1978 to approximately \$775 million in 1981. As a consequence, the complaint noted, during the year preceding the filing of the complaint, R&T's fee increased from approximately \$2 million to \$4 million. The complaint alleged that these fees were "excessive" and "exorbitant" in view of the "routine and administrative" nature of the services that R&T rendered to the Fund. J.A. 5a-8a.

The plaintiff recited that he had not made demand on the Fund or its directors to institute this action because no such demand is required under Section 36(b). In addition, the complaint alleged that the directors' prosecution of any Section 36(b) claim against R&T would be "hostile" to the suit's success since all of the directors were dependent on R&T for their positions and all had participated in establishing R&T's fees.

The district court dismissed the complaint on the basis of Fed. R. Civ. P. 23.1 because the plaintiff had not made a prelitigation demand upon the board of directors (J.A. 20a). The court found that plaintiff had not pleaded sufficient self-interest or bias on the part of the investment company's disinterested directors to excuse demand in this case (*id.* at 21a). The court of appeals (Kaufman, Feinberg, Friendly, JJ.) reversed, finding that actions under Section 36(b) are not subject to a demand requirement. Observing (J.A. 28a; footnote omitted) that "the Rule 23.1 demand requirement applies only when a corporation or association has 'failed to enforce a right which may properly be asserted by it,'" the court concluded that no such requirement applies to Section 36(b) actions because the language of that provision and the legislative history of the Investment Company Act of 1940 show that Congress did not create a corporate right of action (J.A. 30a-46a). The court also noted that, because of the distinctive nature of the Section 36(b) action, there is no policy reason for imposing a demand requirement (J.A. 46a-48a).

SUMMARY OF ARGUMENT

The court of appeals correctly concluded that an investment company security holder who brings suit under Section 36(b) of the Investment Company Act of 1940 to challenge the compensation paid to the company's investment adviser need not make demand upon the company's board of directors before filing his action.

1. Petitioners and the two courts of appeals that have required such demand have proceeded from the erroneous premise that Fed. R. Civ. P. 23.1 imposes a demand requirement. In fact, however, Rule 23.1 merely requires a derivative suit plaintiff to plead whether demand was made and, if not, why. As a rule of procedure, Rule 23.1 does not and indeed cannot impose a demand requirement. Rather, the traditional demand requirement applicable to derivative actions is a principle of substantive state corporation law. The issue in this case, therefore, is whether the demand requirement traditionally imposed in derivative suits is consistent with the unique private cause of action created by Section 36(b).

2. That prelitigation demand is not required in security holder actions under Section 36(b) is apparent from the abuses that led to its enactment, the nature of the cause of action, and the purposes served by the traditional demand requirement.

a. Congress's reason for creating the Section 36(b) security holder suit is fundamentally inconsistent with the underlying rationale of the traditional demand requirement. The demand requirement gives effect to the principle that ordinarily a corporation, through its directors, is capable of controlling its own affairs, including matters relating to litigation. Section 36(b), in contrast, reflects a congressional determination that, due to conflicts of interest in assessing the fairness of compensation paid to a company's investment adviser, courts cannot defer to the business decisions of investment company directors.

A major impetus for the 1970 Amendments to the Investment Company Act of 1940 (Pub. L. No. 91-547, 84 Stat. 1413 *et seq.*), which added Section 36(b), was the inadequate recourse available under state law to an investment company security holder seeking to challenge the fairness of compensation arrangements between the company and its investment adviser. The judicial deference ordinarily given directors' business judgment in approving such contracts had insulated them from judicial review except where corporate waste could be shown. Section 36(b) was enacted to provide security holders with a federal remedy free from such strictures of state law. In particular, Section 36(b) (2) of the Act, 15 U.S.C. 80a-35(b) (2), expressly limits the weight to be accorded the business judgment of the directors to that which a court deems appropriate.

b. The demand requirement has relevance only in the true derivative situation, since it affords the corporation the initial opportunity to pursue its claim. Where the corporation has no right of action, demand has no place. By its terms, Section 36(b) grants no cause of action to the investment company, but instead authorizes suits only by the Commission and security holders. And no cause of action should be implied in favor of the investment company. Congress expressly rejected proposals to permit investment companies to bring suit under Section 36(b). Congress concluded, based upon detailed studies chronicling a long history of abuses, that investment company participation in advisory fee litigation would be of little or no benefit, if not actually counterproductive.

The fact that security holder actions under Section 36(b) are brought "on behalf of" the investment company does not mean that such suits are true derivative actions. Rather, that language merely signifies that recovery must be paid to the company rather than to the individual security holder plaintiff. Nor does that language mean that the company itself may sue. Security holders who file actions under Section 36(b) do not assert a claim derived from the company, but act as "private attorneys general" in enforcing that provision.

c. The demand requirement would serve no meaningful purpose and would frustrate full recovery. In the usual derivative situation, demand affords the corporation's directors an opportunity to consider the transaction at issue, to ratify the challenged corporate action, or to move to block the suit on the ground that it is contrary to the corporation's best interests. In contrast, under the Investment Company Act of 1940, the directors will already have considered the fairness of fee arrangements since they are obligated by statute to do so. Furthermore, while demand ordinarily provides an opportunity for directors to ratify the challenged transaction, thereby restricting the scope of judicial review, Section 36(b)(2) expressly limits the weight to be accorded to the directors' approval of an advisory fee contract. Finally, as this Court observed (*Burks v. Lasker*, 441 U.S. 471, 484 (1979)), investment companies may not cut off security holder actions brought pursuant to Section 36(b).

In an effort to show that prelitigation demand would serve some purpose in Section 36(b) suits, petitioners suggest that it might encourage out of court settlements, but that suggestion ignores the special characteristics of Section 36(b) litigation. In traditional derivative suits, demand may bring to the directors' attention claims of which they were previously unaware or that they did not fully appreciate. The corporation, which may itself assert those claims, can then effectively negotiate with prospective defendants. By contrast, in a Section 36(b) suit, demand will not alert the directors to new claims, since they are required by statute to evaluate the fairness of and approve advisory fees. And since the investment company may not sue under Section 36(b), it is in a poor position to negotiate a settlement.

While requiring prelitigation demand would serve little useful purpose, it could have serious detrimental consequences, especially because recovery under Section 36(b) is limited to the actual damages suffered beginning one year prior to the filing of suit (Section 36(b)(3), 15

U.S.C. 80a-35(b)(3)). A demand requirement would necessarily delay institution of suit, thereby insulating some excessive advisory fees from judicial redress.

3. If this Court should hold that prelitigation demand is required in Section 36(b) actions, we urge the Court to reaffirm its statement in *Burks v. Lasker*, *supra*, 441 U.S. at 484, that investment company management cannot block or hobble such actions. Management interference with security holder actions would place an increased enforcement burden on the Commission and would harm the interests of investment company security holders.

ARGUMENT

I. A SECURITY HOLDER WHO BRINGS SUIT UNDER SECTION 36(b) OF THE INVESTMENT COMPANY ACT OF 1940 TO CHALLENGE THE FAIRNESS OF THE COMPENSATION PAID TO THE COMPANY'S INVESTMENT ADVISER NEED NOT MAKE A PRELITIGATION DEMAND UPON THE COMPANY'S BOARD OF DIRECTORS

A. Fed. R. Civ. P. 23.1 is simply a rule of pleading and does not impose a demand requirement

Both petitioners (Br. 5-9) and the two courts of appeals that have required prelitigation demand in Section 36(b) security holder suits (see *Weiss v. Temporary Investment Fund, Inc.*, 692 F.2d 928, 930, 936 (3d Cir. 1982), petition for cert. pending, No. 82-1592; *Grossman v. Johnson*, 674 F.2d 115, 118-120 (1st Cir. 1982), cert. denied, No. 81-2361 (Oct. 4, 1982)), have assumed that Fed. R. Civ. P. 23.1 itself imposes a demand requirement. This premise is contrary to the language of the rule and would convert what is merely a pleading requirement into a substantive rule of federal law.

By its terms, Rule 23.1 does not require that demand be made upon the corporation's board of directors, but only that "[t]he complaint *shall* * * * *allege* with particularity the efforts, *if any*, made by the plaintiff to obtain the action he desires from the directors or com-

parable authority * * * and the reasons for his failure to obtain the action or for not making the effort" (emphasis added).¹ In this case, plaintiff satisfied this provision by pleading with sufficient particularity that he had not made a demand because it is not necessary to do so in Section 36(b) actions.

If Rule 23.1 imposed a substantive demand requirement, it would violate 28 U.S.C. 2072, which provides that rules of civil procedure may not "abridge, enlarge or modify any substantive right." See *Mississippi Publishing Corp. v. Murphree*, 326 U.S. 438, 445-446 (1946); *Sibbach v. Wilson & Co.*, 312 U.S. 1, 14 (1941). This Court has recognized that Rule 23.1 "neither create[s] nor exempt[s] from liabilities, but require[s] complete disclosure to the court and notice to the parties in interest." *Cohen v. Beneficial Industrial Loan Corp.*, 337 U.S. 541, 556 (1949). The issue in this case, then, is not whether demand is required by Rule 23.1 but whether the traditional demand requirement of state corporation law is "consistent" with the cause of action created by Section 36(b). See *Burks v. Lasker*, *supra*, 441 U.S. at 479; *Johnson v. Railway Express Agency*, 421 U.S. 454, 465 (1975); *Sola Electric Co. v. Jefferson Co.*, 317 U.S. 173, 176 (1942).

B. Requiring prelitigation demand in security holder actions under Section 36(b) would be inconsistent with that unique cause of action

When Congress enacted Section 36(b) in 1970 (Pub. L. No. 91-547, Section 20, 84 Stat. 1428), it created a unique federal cause of action that departed from the pattern of the typical derivative suit. It is apparent from the nature of that cause of action, its legislative history, and the purposes served by the traditional demand requirement that prelitigation demand is not required under Section 36(b).

¹ Rule 23.1 likewise does not prescribe the consequences that flow from the failure to make a demand or the circumstances in which demand may be excused.

1. Congress's reason for creating security holder actions under Section 36(b) is contrary to the rationale for the prelitigation demand requirement

Resolution of the director demand issue presented by this case requires an understanding of the dramatically different purposes served by the demand requirement traditionally applicable in derivative suits and the unique cause of action conferred upon security holders by Section 36(b). The demand requirement gives effect to the principle that corporations, acting through their boards of directors, are ordinarily capable of controlling their own affairs, including matters relating to litigation. *Delaware & Hudson Co. v. Albany & S. R.R.*, 213 U.S. 435, 446 (1909); *Haues v. City of Oakland*, 104 U.S. 450, 457 (1882). Because courts are reluctant to interfere with directors' business judgments, a corporate decision to forego litigation, like other business decisions, is ordinarily honored. See *United Copper Securities Co. v. Amalgamated Copper Co.*, 244 U.S. 261, 263-264 (1917).

Section 36(b), by contrast, reflects a congressional determination that, due to conflicts of interest in assessing the fairness of compensation paid to a company's investment adviser, courts cannot defer to the business decisions of investment company directors. Thus, Congress's reason for creating the Section 36(b) security holder action is fundamentally inconsistent with the underlying rationale of the traditional demand requirement.

Flagrant abuses in the investment company industry prompted enactment of the Investment Company Act of 1940 and, later, Section 36(b). We review briefly the relevant industry abuses and the legislative provisions designed to remedy them.

a. An investment company is a pool of liquid assets owned by its security holders. As usually structured, an investment company is controlled by a separate entity, commonly called an investment adviser. The adviser typically organizes and promotes the investment company,

provides management services, selects the company's investments, handles sales of the company's shares through an associated underwriter, and supervises the business operations of the company. Persons affiliated with the adviser usually serve on the board of directors of the investment company. Thus, the adviser of an investment company typically exercises at least as much control over the company as internal management does in other corporations. This method of organization causes special problems. Although the primary goal of management should be to maximize the corporation's profits and thus the return to its investors, an investment adviser is also motivated by a desire to maximize its own profits. See *Burks v. Lasker*, *supra*, 441 U.S. at 480-481; *Tannenbaum v. Zeller*, 552 F.2d 402, 405 (2d Cir.), cert. denied, 434 U.S. 934 (1977); S. Rep. No. 91-184, 91st Cong., 1st Sess. 5 (1969).

Enactment of the Investment Company Act of 1940 was prompted, in large part, by abuses arising from such conflicts of interest. In its *Report on the Study of Investment Trusts and Investment Companies*, H.R. Doc. No. 279, (Pt. 3), 76th Cong., 1st Sess. 1-2483 (1939), the Securities and Exchange Commission identified these abuses as including self-dealing, larceny, and embezzlement by investment company management. See also S. Rep. No. 1775, 76th Cong., 3d Sess. 6-8 (1940). After receiving this report, Congress concluded that the public interest was adversely affected when investment companies were managed "in the interest of directors, officers, [or] investment advisers . . . rather than in the interest of . . . security holders." Section 1(b)(2), 15 U.S.C. 80a-1(b)(2). The Investment Company Act of 1940 was intended to "mitigate and, so far as is feasible, . . . eliminate . . . conditions . . . which adversely affect the national public interest and the interest of investors." Section 1(b), 15 U.S.C. 80a-1(b).

To combat these abuses, Congress created a regulatory scheme that imposed some controls on company manage-

ment but did not eliminate the dominance of investment companies by their advisers. See *United States v. National Association of Securities Dealers, Inc.*, 422 U.S. 694, 704-705 & n.13 (1975). In the area of investment adviser compensation, the Act provided a "few elementary safeguards" designed to prevent abuses. *Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency*, 76th Cong., 3d Sess., Pt. 1, 251-252 (1940) (Statement of David Schenker, Chief Counsel, SEC Investment Trust Study); *Mutual Fund Legislation of 1967: Hearings on S. 1659 Before the Senate Comm. on Banking and Currency*, 90th Cong., 1st Sess., Pt. 1, 3 (1967) (Statement of Manual F. Cohen, Chairman, SEC) (hereinafter cited as "*1967 S. Hearings*"). At least 40% of the directors were required to be persons other than officers or employees of the company or persons "affiliated"² with its adviser. Act of Aug. 22, 1940, ch. 686, Title I, Section 10(a), 54 Stat. 806. Congress intended for these directors to "furnish an independent check upon the management" of investment companies. *Investment Trusts and Investment Companies: Hearings on H.R. 10065 Before a Subcomm. of the House Comm. on Interstate and Foreign Commerce*, 76th Cong., 3d Sess. 109 (1940). In addition, initial approval of the advisory fee contract was vested in the majority of outstanding voting security holders, and the board of directors or security holders were required to approve annually any continuation of the contract beyond two years. Section 15(a), 15 U.S.C. 80a-15(a). Finally, any renewal of the contract was required to be approved by a majority of either the unaffiliated directors or the holders of the outstanding shares. Section 15(c) of the Act of Aug. 22, 1940 (54 Stat. 813).

² For the definition of "[a]ffiliated person," see Section 2(a)(3) of the Act, 15 U.S.C. 80a-2(a)(3).

b. Dramatic growth in the size of mutual funds during the 1950's and 1960's prompted the Commission to authorize two studies of the investment company industry.³ Of particular concern to the Commission was whether, as investment companies' assets grew, economies of scale in management costs were being passed on to the individual investors.⁴ As stated at hearings in 1969, "it does not cost 10 times as much to manage a \$1 billion fund as it costs to manage a \$100 million fund." *Investment Company Amendments Act of 1969: Hearings on S. 34 and S. 296 Before the Senate Comm. on Banking and Currency*, 91st Cong., 1st Sess. 9 (1969) (Statement of Hugh F. Owens, Commissioner, SEC) (hereinafter cited as "1969 S. Hearings"). See also *id.* at 17; S. Rep. No. 91-184, *supra*, at 6; *SEC Report on Public Policy Implications of Investment Company Growth*, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 10-11 (1966).

In 1958, the securities research unit of the Wharton School of Finance and Commerce of the University of Pennsylvania commenced a Commission-authorized study on the effects of growth in the mutual fund industry. The resulting Wharton Report, which was transmitted to Congress in 1962, found that investment advisers tended to charge mutual funds "substantially higher" rates than they charged other clients. *Wharton School*

³ In 1940, Congress had recognized the potential for future problems in the industry and had authorized the Commission to conduct studies, report the results of its investigations, and make recommendations if "any substantial further increase in size of investment companies create[d] any problem involving the protection of investors or the public interest * * *." Section 14(b), 15 U.S.C. 80a-14(b).

⁴ From 1940 to 1969, the net assets of the mutual fund industry grew from one half billion dollars to over \$50 billion. By September 30, 1982, the industry's net assets had reached more than \$281 billion. 1982 SEC Ann. Rep. 96.

Study of Mutual Funds, H.R. Rep. No. 2274, 87th Cong., 2d Sess. 29 (1962). The report stated that the prevalent practice in the industry was to calculate advisory fees on the basis of a fixed percentage of assets managed, rather than on services rendered or actual expenses (*id.* at 28-29). The report concluded that mutual funds lacked effective bargaining power in the establishment of advisory fee rates because they were, in essence, "legal shells" dependent on their external investment advisers (*id.* at 30, 66-67). The report also found unaffiliated directors to be "of restricted value as an instrument for providing effective representation of mutual fund shareholders in dealings between the fund and its investment adviser" (*id.* at 34).

The Wharton Report made no legislative recommendations, and accordingly, when the Commission transmitted that report to Congress, the Commission stated that it would evaluate the public policy questions raised and would itself report to Congress at a later time. In 1966, the Commission issued a Report on the Public Policy Implications of Investment Company Growth, and that report found that lawsuits by security holders challenging excessive advisory fees had been largely fruitless. H.R. Rep. No. 2337, *supra*, at 128-130. The report found that the existing provisions of the Investment Company Act of 1940 concerning approval of advisory fee contracts had not only failed to serve as an effective check on management but had proven detrimental to shareholders who attempted to challenge advisory fees. H.R. Rep. No. 2337, *supra*, at 142. The report noted that courts would generally review the fairness or reasonableness of corporate transactions in which a director has a personal interest. But the report found that in the three litigated cases challenging the fairness of mutual fund advisory fee agreements, the courts had pointed to the approval of those contracts by the security holders or unaffiliated directors and had therefore changed the applicable standard from simple fairness or reasonableness

to the much more permissive standard of waste of corporate assets. *Acampora v. Birkland*, 220 F. Supp. 527, 548-549 (D. Colo. 1963); *Saxe v. Brady*, 40 Del. Ch. 474, 486, 184 A.2d 602, 610 (1962); *Meiselman v. Eberstadt*, 39 Del. Ch. 563, 568, 170 A.2d 720, 723 (1961).⁵ Thus the very protection created by Congress to prevent unfair fee agreements had been transformed into an instrument to avoid judicial scrutiny of those contracts.

c. To remedy these inadequacies, the Commission submitted to Congress a series of legislative proposals that resulted in the 1970 Amendments to the Act. These amendments sought to curb abuses relating to advisory fee contracts in essentially two ways. First, the investment company board was made more independent and was given a greater role in approving advisory fee agreements. Section 10(a), 15 U.S.C. 80a-10(a), was amended to require that at least 40% of the directors not be "interested persons," a category broader than that to which the same proscription had previously applied. See Section 2(a)(19), 15 U.S.C. 80a-2(a)(19). Congress retained the provisions requiring that shareholders initially approve any advisory contract and that any continuance beyond two years be approved by the board of directors or the shareholders. Section 15(a)(2), 15 U.S.C. 80a-15(a)(2). In addition, Section 15(c), 15 U.S.C. 80a-15(c), was amended to place independent responsibility on the disinterested directors to approve any advisory contract. Congress also imposed an obligation on these directors to request and evaluate—and a correlative duty on investment advisers to furnish—information relevant to an assessment of the contract (*ibid.*).

⁵ Similar obstacles had been encountered by security holders who challenged the fairness of advisory fees under provisions of the Investment Company Act of 1940. Litigants who sought relief under former Section 36, Act of Aug. 22, 1940, ch. 686, Title I, 54 Stat. 841, were required to prove gross abuse of trust. See *Brown v. Bullock*, 194 F. Supp. 207 (S.D.N.Y. 1961), *aff'd*, 294 F.2d 415 (2d Cir. 1961). See 1969 S. Hearings, *supra*, at 30; 1967 S. Hearings, *supra*, at 117-118.

Congress was not content, however, to rely solely upon the strengthened independence of the board of directors. It recognized that even the disinterested directors could not be relied upon fully to protect the security holders' interests in matters concerning advisory compensation. Accordingly, a new cause of action was created that allowed security holders to test the fairness of advisory fee contracts without encountering some of the chief stumbling blocks that had characterized prior litigation. Whereas security holders who challenged such contracts had previously been required to prove corporate waste, Section 36(b) imposes a fiduciary duty on the investment adviser with respect to receipt of compensation from the investment company. Moreover, this section authorizes the Commission, as well as individual security holders acting on the company's behalf, to institute an action for breach of that duty. When a security holder institutes suit under that provision, the Commission is authorized to intervene. Section 44, 15 U.S.C. 80a-43. In a marked departure from prior law, the statute provides that any approval of the advisory contract by the board of directors or shareholders of the investment company should be given only "such consideration by the court as is deemed appropriate under all the circumstances." Section 36(b)(2), 15 U.S.C. 80a-35(b)(2). The Senate Report noted that some consideration was due management's judgment regarding the fairness of the fee but emphasized that "such consideration would not be controlling in determining whether or not the fee encompassed a breach of fiduciary duty." S. Rep. No. 91-184, *supra*, at 15.

While creating this potent new remedy, Congress did impose certain significant restrictions. Liability is imposed only upon the recipients of compensation and may not exceed the amount of compensation received. Furthermore, damages may not be recovered for any period prior to one year before institution of the action. Section 36(b)(3), 15 U.S.C. 80a-35(b)(3).

2. *Congress's decision not to authorize investment company suits under Section 36(b) is inconsistent with a prelitigation demand requirement in security holder actions under that provision*

The demand requirement has relevance only in the true derivative situation in which the shareholder asserts a claim that is "not his own but the corporation's." *Koster v. Lumbermen's Mutual Casualty Co.*, 330 U.S. 518, 522 (1947) (footnote omitted). See *Price v. Gurney*, 324 U.S. 100, 105 (1945); *Delaware & Hudson Co. v. Albany & S. R.R.*, *supra*, 213 U.S. at 447. Demand thus affords the corporation the opportunity to proceed on its own behalf if it chooses to do so. Accordingly, since an investment company may not itself bring suit under Section 36(b), the chief reason for prelitigation demand is absent. Moreover, Congress's deliberate decision not to authorize investment company suits indicates a strong congressional belief that the company's participation in litigation concerning the reasonableness of advisory fees would be of little or no benefit, if not actually counterproductive. As the court below aptly put it (J.A. 44a-45a): "The relationship of a Fund to its adviser makes it a part of the problem in a way that precludes it from being part of the solution, at least at the litigation stage."⁶

a. Petitioners (Br. 9-14) and the courts of appeals that have required prelitigation demand in cases such as this (*Weiss v. Temporary Investment Fund, Inc.*, *supra*, 692 F.2d at 934-935; *Grossman v. Johnson*, *supra*, 674 F.2d at 120) maintain that an investment company has an im-

⁶ It is irrelevant that an investment company may challenge an excessive advisory fee by asserting a state claim for corporate waste (compare Pet. Br. 15-16; Investment Company Institute Amicus Br. 13-15). As we have noted, Congress enacted Section 36(b) in large measure because corporate waste actions had proven ineffective as a remedy for excessive advisory fees. It is therefore untenable to suggest that Congress intended to require prelitigation demand, which would delay institution of potentially efficacious Section 36(b) suits, in order to permit the investment company to prosecute a suit for corporate waste.

plied cause of action under Section 36(b). That argument, however, flies in the face of the statutory language and the legislative history.

This Court has recognized that the central inquiry in determining whether a private right of action should be implied is congressional intent. *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*, 456 U.S. 353, 377-378 (1982); *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 15-16 (1979). And of course, the starting place for determining that intent is the language of the statute. See, e.g., *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976).

In this case, the statutory language speaks with particular clarity. Section 36(b) expressly authorizes suit by security holders and the Commission but makes no mention of actions by investment companies. Thus, on the face of the statute, it is difficult to conclude that Congress intended to authorize investment company suits but simply neglected to say so expressly.⁷

At all events, the legislative history of the provision refutes any such conjecture. The fact is that Congress specifically considered and rejected a proposal that would have allowed investment companies themselves to sue, as well as another proposal that would have expressly made the security holder action derivative in nature.

The bill originally proposed by the Commission contemplated that the Commission could sue to enforce the suggested reasonable compensation requirement under its

⁷ Whether an investment company has an implied right of action under Section 36(b) is of course distinct from the question whether there may be implied remedies under other provisions of the Investment Company Act of 1940. In enacting Section 36(b), Congress clearly did not intend to preempt implied remedies under other provisions of the Act. Both the Senate and House Reports on the 1970 Amendments state: "[a]lthough section 36(b) provides for an equitable action for breach of fiduciary duty as does section 36(a), the fact that subsection (b) specifically provides for a private right of action should not be read by implication to affect subsection (a)." S. Rep. No. 91-184, *supra*, at 16; H.R. Rep. No. 91-1382, 91st Cong., 2d Sess. 38 (1970).

existing statutory enforcement authority. That bill did not expressly authorize private suits, but it contained references to "damage" actions and gave the Commission authority to intervene in any action brought "by or on behalf of a registered investment company." S. 1659, 90th Cong., 1st Sess. §§ 8(d), 23 (1967); *1967 S. Hearings, supra*, at 45. It therefore appears to have assumed that such actions could be brought both by investment companies and their shareholders.

The investment company industry opposed giving the Commission the authority to enforce the fairness of advisory contracts for fear that such power would be tantamount to rate-making authority. *1967 S. Hearings, supra*, at 197. The industry therefore proposed that actions to enforce the fairness standard "be brought only by the company or a security holder thereof on its behalf * * *." *Id.* at 100-101. As a result of these and other objections, a revised bill was passed by the Senate in July 1968. S. 3724, 90th Cong., 2d Sess. (1968). That bill rejected the industry's objection to Commission suits. It required a security holder to make demand on the Commission before filing suit. And if the Commission refused or failed to bring suit within six months, the bill provided that the security holder could maintain an action in a "derivative" or representative capacity. S. 3724, 90th Cong., 2d Sess. § 8(d)(6) (1968). The industry's suggestion that the investment company itself be expressly authorized to sue was rejected. The bill, however, retained the provision allowing the Commission to intervene in any action brought by the company or by a security holder on its behalf. S. 3724, 90th Cong., 2d Sess. § 22 (1968).

This bill was reintroduced in the 91st Congress. Following further hearings and discussions between representatives of the Commission and the industry, the present version of Section 36(b) was drafted and enacted. See S. 2224, 91st Cong., 1st Sess. § 20(b) (1969); 115 Cong. Rec. 13648 (1969) (Statement of Sen. McIntyre). The specific reference in the prior version to the deriva-

tive or representative nature of the security holder action was eliminated, together with the reference in the intervention provision to actions brought by the investment company itself. See S. 2224, *supra*, § 22. This legislative history unmistakably suggests that Congress intended for the Commission and security holders to be the sole enforcers of the fiduciary duty imposed on investment advisers by Section 36(b).⁸

b. It is irrelevant for present purposes that a security holder action under Section 36(b) is brought "on behalf of such company." That language indicates that such an action is brought for the company's benefit and that any recovery is to be paid to the company rather than the individual security holder plaintiff.⁹ But it does not follow that the company itself is authorized to bring suit. As the Second Circuit recognized, "[t]he [Section 36(b)] action is not, strictly speaking, 'derivative' in the sense of deriving from a right properly asserted by the corpora-

⁸ Our position here is consistent with the argument recently made by the Commission in *Herman & MacLean v. Huddleston*, No. 81-680 (Jan. 24, 1983), in which the Commission contended that implied rights of action should be recognized under another provision of the securities laws. In that case, we were concerned that if an implied right of action was not recognized there would be no damage remedy for certain misconduct. Here, Section 36(b) expressly affords investors a useful remedy, and no implied action is necessary to make that statute effective.

⁹ Furthermore, in the case of an open-end investment company like the Fund in this case, it is largely a legal fiction to state that recovery obtained in a Section 36(b) action is on behalf of the company rather than the security holders. An open-end investment company issues securities redeemable at a price calculated as a pro rata portion of the current net asset value of the company. See Sections 2(a)(32) and 5(a)(1) of the Act, 15 U.S.C. 80a-2(a)(32) and 80a-5(a)(1). Any increase in this net asset value as a result of a favorable judgment would automatically be reflected in the redemption price of the securities. Thus, while recovery in a Section 36(b) suit would initially be paid to the investment company, the company would serve as a conduit for the benefit of holders of redeemable securities.

tion, but rather constitutes individual security holders as 'private attorneys general' to assist in the enforcement of a duty imposed by the statute on investment advisers" (Pet. App. 23a). In other words, security holders who file actions under Section 36(b) act in a capacity similar to that of the Commission when it brings suit under the statute. Since it could hardly be maintained that the Commission must make prelitigation demand, the same should be true for security holders.

The essential difference between a Section 36(b) action and a traditional derivative suit is illustrated by the fact that Section 36(b) authorizes suit, not by "shareholders," but by "security holders." This choice of broader terminology was obviously deliberate in view of Congress's use of the word "shareholder" in Section 36(b)(2). The class of potential plaintiffs under Section 36(b) thus includes holders of debt instruments issued by an investment company.¹⁰ By contrast, it is well settled that traditional derivative actions may be brought only by equity holders. See 3B J. Moore & J. Kennedy, *Moore's Federal Practice* ¶ 23.1.17, at 23.1-68 to 23.1-69 (2d ed. 1982) and cases cited therein; 7A C. Wright & A. Miller, *Federal Practice and Procedure* § 1826 (1972 & Pocket Part 1982). Unlike creditors, equity shareholders are deemed to possess the corporation's residual managerial authority and may consequently protect the corporation's interests when management fails or refuses to do so. See *Ashwander v. Tennessee Valley Authority*, 297 U.S. 288, 321 (1936); *Kauffman v. Dreyfus Fund, Inc.*, 434 F.2d 727, 735-736 (3d Cir. 1970); 13 W. Fletcher, *Fletcher Cyclopedic Corporations* § 5972.2, at 455 (Perm. ed. 1980). Thus, a security holder suit under Section 36(b) is not one in which persons who may be said to own part of the invest-

¹⁰ Examples of registered investment companies that may issue debt instruments include closed-end companies and face-amount certificate companies. See Sections 2(a)(15) and 18 of the Act, 15 U.S.C. 80a-2(a)(15) and 80a-18. The Commission's most recent report to Congress indicates a total of 170 registered closed-end investment companies. 1982 SEC Ann. Rep. 95.

ment company are permitted to assert a claim belonging to their company. Rather, it is a suit in which members of a broader group, including creditors, may assert an independent cause of action.¹¹

3. *A demand requirement in Section 36(b) actions would serve no meaningful purpose and would frustrate full recovery*

While serving a legitimate purpose in traditional derivative suits, a demand requirement would be of little value in Section 36(b) actions and would frustrate full recovery.

a. In traditional derivative actions, the demand requirement is premised upon the view that corporate management should be afforded the initial opportunity to pro-

¹¹ Petitioners (Br. 8) and amicus (Investment Company Institute Br. 7, 19-20) argue that the Commission acknowledged the applicability of the demand requirement in stating to Congress that the Federal Rules of Civil Procedure provide adequate safeguards against strike suits brought under Section 36(b). Petitioners cite (Br. 8) a footnote to Commission Chairman Budge's oral statement in House Hearings referring to the class action protections in Rule 23. They err, however, in assuming that Chairman Budge actually intended to refer to Rule 23.1 when in fact it seems clear that he meant precisely what he said when he referred to Rule 23, Fed. R. Civ. P. The security holder action under Section 36(b) may be viewed as a class action maintainable under Rule 23(b)(1)(B). See Fed. R. Civ. P. 23, Advisory Committee Note to 1966 Amendment and cases cited therein. The principal protection against strike suits in the class action rule is the requirement of judicial approval of settlements; there are no provisions relating to demand in Rule 23.

Even if Chairman Budge had meant Rule 23.1, the chief protection against strike suits found in Rule 23.1, as in Rule 23, is the requirement of court approval of settlements. 7A C. Wright & A. Miller, *Federal Practice and Procedure* §1839, at 427-428 (1972). Clearly Rule 23.1's pleading requirements concerning demand are not designed to deter strike suits. And contrary to petitioners' contention (Br. 17-18), the demand requirement itself has not generally been recognized as a deterrent to strike suits, although it may have that incidental effect. Instead, as we have noted, its main purpose is to give the corporation an opportunity to vindicate its own rights.

tect the corporation's rights and that shareholders should be permitted to sue on the corporation's behalf only where management is unwilling or unable to take proper action. *United Copper Securities Co. v. Amalgamated Copper Co.*, *supra*, 244 U.S. at 263-264; *Delaware & Hudson Co. v. Albany & S. R.R.*, *supra*, 213 U.S. at 446-447. Prelitigation demand affords the directors an opportunity to consider, in the exercise of their business judgment, whether to ratify the transaction or to have the corporation prosecute the action. *Brody v. Chemical Bank*, 517 F.2d 932, 934 (2d Cir. 1975). Two other purposes of demand have been suggested. One is that a prelitigation demand on directors provides corporate management with an advance opportunity to evaluate whether, if it rejects demand as not in the best interests of the corporation, the corporation should seek to preclude prosecution of the cause of action by the shareholder. See *Stadin v. Union Electric Co.*, 309 F.2d 912, 921-922 (8th Cir. 1962), cert. denied, 373 U.S. 915 (1963); *Swanson v. Traer*, 249 F.2d 854, 858 (7th Cir. 1957). A second is that a demand on directors will stimulate extra-judicial resolution of intra-corporate disputes, thereby avoiding litigation.

Insofar as demand is intended to allow the corporation to bring its own action, that purpose has no application here since, as we have shown, there is no corporate cause of action under Section 36(b). The other purposes of demand would likewise not be served here.

First, the disinterested directors of an investment company are required by statute to pass upon the fairness of all advisory fee contracts. Under the Investment Company Act of 1940, the advisory contract and any renewal of the contract must be approved by a majority of the disinterested directors, and prior to approval the directors are expressly required to request and evaluate information concerning the fairness of the contract. See Section 15(c), 15 U.S.C. 80a-15(c). In addition, if that contract continues in effect for more than two years, it must be renewed annually by the board of directors or by a majority vote of security holders. See Section 15(a)(2), 15 U.S.C.

80a-15(a)(2). If the directors find that an advisory fee contract is unfair, they are obligated to take appropriate action, which could include modification or termination of the advisory contract. See Section 15(a)(3), 15 U.S.C. 80a-15(a)(3). Given these statutory duties imposed upon the directors, prelitigation demand is not needed to bring to their attention possible inequities in advisory fee agreements. In virtually all instances, such demand would only inform them of matters they had previously considered and approved.

Second, in Section 36(b) suits, directors lack their usual authority to ratify challenged corporate actions and thereby restrict the scope of judicial review. Section 36(b)(2) instructs courts to give director approval of advisory fee contracts only such consideration as the court determines to be appropriate,¹² and the legislative history of this provision shows that Congress intended such approval to be given restricted weight. The Senate first rejected an investment company industry proposal requiring courts to defer to the business judgment of the disinterested directors in approving the advisory fee contract in the absence of "clear and convincing evidence that the . . . directors . . . [had] abuse[d their] business judgment." 1967 S. Hearings, *supra*, at 101. Under a later version of the bill, courts were directed to give "substantial" weight to board of director determinations concerning the reasonableness of such fees. The courts were likewise instructed that shareholder ratification or approval was entitled to appropriate consideration in light of all the circumstances. Furthermore, if both the shareholders

¹² As the Commission made clear in a memorandum submitted during House hearings following Senate passage of Section 36(b), "[t]he adoption of this [fiduciary duty] standard [in Section 36(b)] precludes the assertion of a claim of ratification." *Mutual Fund Amendments: Hearings on H.R. 11995, S. 2224, H.R. 13754, and H.R. 14737 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce, 91st Cong., 1st Sess., Pt. 1, 188 (1969)*. See also *id.* at 138, 177.

and disinterested directors approved the contract, it was presumed to be reasonable. S. 3724, 90th Cong., 2d Sess. § 8(d) (1) (1968). The statute finally enacted, however, rejected these provisions. As previously noted, the Senate Report emphasized that the directors' judgment "would not be controlling in determining whether or not the fee encompassed a breach of fiduciary duty." S. Rep. No. 91-184, *supra*, at 15. See also *Mutual Fund Amendments: Hearings on H.R. 11995, S. 2224, H.R. 13754, and H.R. 14737 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce*, 91st Cong., 1st Sess., Pt. 1, 177 (1969).

The third reason why prelitigation demand would be of little value in Section 36(b) suits is that directors may not seek termination of such actions. A corporation may sometimes attempt to block a traditional derivative action if, in the business judgment of its directors, prosecution of the claim is not in the best interests of the corporation. *Burks v. Lasker*, *supra*, 441 U.S. at 485. But this Court in *Burks* (441 U.S. at 484) distinguished the Section 36(b) action as an exception to this general rule, since Section 36(b) (2) expressly limits the weight to be accorded director approval of the advisory contract. Accord, J.A. 46a; *Weiss v. Temporary Investment Fund, Inc.*, *supra*, 692 F.2d at 939. See also *Grossman v. Johnson*, *supra*, 674 F.2d at 121.

In an effort to show that prelitigation demand would serve some purpose in Section 36(b) actions, petitioners claim (Br. 17-18) that it might spur the investment company to settle the claim out of court and thus avoid litigation. This argument will not bear analysis. We do not doubt that prelitigation demand may sometimes lead to settlement when a traditional derivative action is contemplated. In that situation, demand may bring to management's attention claims of which it was previously unaware or that it did not fully appreciate. And since the corporation can itself assert those claims in court and can often marshal considerable litigative resources, it can

effectively negotiate with prospective defendants. By contrast, in the case of a Section 36(b) security holder action, demand will not alert the directors to any new claims, since the disinterested directors are required by statute to evaluate the reasonableness of and to approve all advisory fee agreements. And since the company cannot bring suit under Section 36(b), its bargaining power in settlement negotiations is unlikely to exceed that of a security holder, who can sue but will usually have a strong incentive to avoid costly litigation if possible. In short, it is difficult to see how prelitigation demand would aid in the settlement of prospective Section 36(b) suits.

b. Requiring prelitigation demand in Section 36(b) actions would also be inconsistent with Section 36(b)(3), which limits recovery to actual damages suffered beginning one year before commencement of the action.¹³ A prelitigation demand requirement would cause delay while the directors evaluated the claim,¹⁴ thereby permitting months of potentially exorbitant fees to pass beyond the court's reach. Similarly, if a security holder filed suit without complying with the demand requirement on the asserted ground that it was excused in the particular circumstances of the case, resolution of the adequacy of the excuse would engender delay, thereby immunizing exces-

¹³ The one-year statute of limitations in Section 36(b) contrasts sharply with the three to six year statutes of limitations applicable to State law claims of corporate waste. See Cal. Civ. Proc. Code § 343 (West 1982) (4 years); Del. Code Ann. tit. 10, § 8106 (1975) (3 years); Md. Cts. & Jud. Proc. Code Ann. § 5-101 (1980) (3 years); Mass. Ann. Laws ch. 260, § 2 (Michie/Law. Coop. 1980) (6 years); N.Y. Civ. Prac. Law & R. § 213 (McKinney 1972) (6 years).

¹⁴ See Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78p(b) (where Congress selected 60 days as a reasonable time for corporate response to security holder demand in actions for recovery of short-swing profits from certain insiders); *Mills v. Esmark, Inc.*, 91 F.R.D. 70, 73 (N.D. Ill. 1981) (where 3½ months was deemed a reasonable time for corporate response).

sive fees from recovery if the excuse question is resolved adversely to the plaintiff. To understand what even a relatively short delay might mean, it should be noted that in 1981 petitioner R&T earned fees of approximately \$4 million, which amounts to \$333,333 per month.

Both the First and Third Circuits addressed this issue, but their analysis, which petitioners approvingly cite (Br. 25-26), is flawed. The First Circuit reasoned (*Grossman v. Johnson, supra*, 674 F.2d at 122) that delay might "change the particular one-year period for which recovery was allowable but would not reduce the one-year recovery period, and probably not decrease the amount." The Third Circuit adopted similar reasoning (*Weiss v. Temporary Investment Fund, Inc., supra*, 692 F.2d at 938). Not only does this reasoning presuppose an unvarying fee based upon services rendered and expenses incurred—and that is not always the case—but it overlooks the fact that the date from which the computation of any recovery begins matters very much. Suppose, for example, that an advisory fee is unvarying and that demand delays the filing of suit by two months. While the security holder (and thus the company) may recover the same amount in the lawsuit, i.e., the excessive fees charged beginning one year prior to the filing of suit, the company will have been charged excessive fees for two more months, and that amount could never be recouped.¹⁵

¹⁵ In view of the holding below that the demand requirement is not applicable to a Section 36(b) action, the court of appeals reserved judgment on the issue of whether demand should have been excused because of the directors' prior participation in fixing the amount of the advisory fee (J.A. 27a n.4). Even under the strict self-interest or bias test employed by the First and Third Circuits (see *Lewis v. Curtis*, 671 F.2d 779, 787 (3d Cir. 1982), cert. denied, No. 81-2224 (Oct. 4, 1982); *Heit v. Baird*, 567 F.2d 1157, 1160 (1st Cir. 1977)), demand should be excused where a majority of the incumbent disinterested directors have previously approved the advisory fee contract. Since those directors have a duty under Section 15(c) of the Act to evaluate the fairness of the adviser's compensation, a conclusion that such compensation is excessive may subject them to financial liability and other sanctions under Section

II. IF PRELITIGATION DEMAND IS REQUIRED IN SECTION 36(b) ACTIONS, A SECURITY HOLDER SHOULD NOT BE PREVENTED FROM INSTITUTING OR MAINTAINING SUIT IF THE DIRECTORS REJECT THE DEMAND

Should this Court require demand in actions under Section 36(b), we urge the Court to make clear that the demand requirement will not carry with it the limitations usually placed on derivative suit plaintiffs following rejection of demand. Security holders should not be subjected to the obligation of showing that rejection of demand was wrongful or of resisting motions to terminate actions on the basis of the business judgment rule. Congress's determination to permit judicial review of the fairness of advisory fees would be undermined if such restrictions were imposed.¹⁶

The consequences of the demand requirement in ordinary derivative suits are well known. A board of directors' determination on "[w]hether or not a corporation shall seek to enforce in the courts a cause of action for damages is, like other business questions, ordinarily a matter of internal management and is left to the discretion of the directors * * *." *United Copper Securities Co. v. Amalgamated Copper Co.*, *supra*, 244 U.S. at 263. See *Corbus v. Alaska Treadwell Gold Mining Co.*, 187 U.S. 455,

36(a) of the Act for personal misconduct in connection with a breach of their duties under Section 15(c). Their self-interest in avoiding such possible consequences should ordinarily excuse demand.

¹⁶ While we previously argued (see page 24, *supra*) that the prohibition against business judgment termination of Section 36(b) actions removes a policy justification for the demand requirement, the question whether demand is required in the first instance is distinct from the question whether a security holder may pursue a claim following rejection of demand. Thus, should the Court disagree with our argument that demand is not required in Section 36(b) actions, that holding should not control the separate question whether, following rejection of demand, a security holder may still pursue a Section 36(b) claim.

463 (1903); *Ashwander v. Tennessee Valley Authority*, *supra*, 297 U.S. at 343 (Brandeis, J., concurring). Where demand is required, courts usually interfere only if the corporation's refusal to pursue a valid claim is "wrongful." See Comment, *The Demand and Standing Requirements in Stockholder Derivative Actions*, 44 U. Chi. L. Rev. 168, 191-200 (1976). Even where demand is excused, a corporation may subsequently terminate the action if, in the directors' business judgment, it is not in the corporation's best interests. *Burks v. Lasker*, *supra*, 441 U.S. at 485.

By contrast, in *Burks v. Lasker*, *supra*, 441 U.S. at 484, this Court observed that corporations may not terminate Section 36(b) actions on the basis of the directors' business judgment. The Court was there invoking Section 36(b)(2), which expressly limits the weight to be accorded director approval of advisory fees. Consistent with this provision, the demand requirement should not operate to bar prosecution of a Section 36(b) claim by a security holder willing to undertake the costs of litigation. To be sure, Section 36(b)(2) by its terms does not deal with the directors' decisions about the prosecution of litigation concerning advisory fees. But since that provision instructs courts not to defer to directors' decisions regarding the reasonableness of the fees themselves, it would be wholly inconsistent if directors could preclude litigation challenging those very fees.

Imposing such restrictions would also create an unwarranted distinction between security holder actions under Section 36(b) and those initiated by the Commission under the same provision. Clearly, neither the demand requirement nor the business judgment rule have force in a Commission action, and the statute draws no distinctions between the two suits. It was for this reason that the court of appeals below concluded (J.A. 33a) that the security holder who brings suit under Section 36(b) acts as a private attorney general. Placing special restrictions upon security holder actions would distort the statutory

scheme in a way that would place a greater enforcement burden on the Commission. Such a result would be contrary to the carefully fashioned congressional scheme under which the private action is the primary vehicle for remedying abuses involving investment advisory fees.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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